2nd QUARTER 2013 EQUITY REPORT

The Solari Report

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Equity Overview with Chuck Gibson:

Secular Trends in the U.S. Equity Markets
Date: April 18, 2013

INTRODUCTION

Catherine Austin Fitts: And now we turn to the "Second Quarter Equity Market Review." In a moment I'm going to bring in Chuck Gibson, who is someone who needs no introduction on the *Solari Report*. Chuck is the managing member of Financial Perspectives in Pleasanton, California in the San Francisco Bay Area. He's also managing member and my partner at Sea Lane Advisory. If you're not familiar with Chuck's work, check out our Equity Market Library. There's great analysis on equity markets from previous quarters.

Chuck Gibson & Catherine Austin Fitts

Chuck has outdone himself on his presentation for this *Solari Report*. There are big questions facing us in the economy, in the worlds and in the market, and they play out as you watch the equity markets. We're going to be talking about them today. Chuck has made some fantastic charts. You'll be following them on Instant Teleseminar. If for any reason you can't, they'll be up on the blog.

PART I: First Quarter Equity Market Recap
Market Performance Review

Catherine: Okay — let's dive right in. It's been a very exciting quarter. It's an exciting time to be an investment advisor, that's for sure.

Index	Mar 2013	QTD	YTD	High	Low	Description
S&P 500	3.8%	10.6%	10.6%	1569	1457	US Largest 500 Company stocks
DJIA	3.9%	11.4%	11.4%	14578	13329	Large-cap stocks
Russell 2000	4.6%	12.4%	12.4%	953.1	872.6	Small-cap stocks
MSCI EAFE	0.4%	3.7%	3.7%	59.9	56.9	Europe, Far East & Australasia (EFA)
MSCI Emrg. Mkts.	-1.0%	-3.6%	3.6%	45.2	41.8	Emerging Markets stocks (EEM)
Barclays Agg. Bond	-0.1%	-0.1%	-0.1%	110.7	109.7	Total US Bond index (AGG)
Barclays H/Y Bond	1.0%	2.0%	2.0%	41.12	40.22	High-yield Corporate Bonds (JNK)
Gold	0.6%	-3.7%	-3.7%	1697.8	1574.0	Gold Spot Price
Silver	-1.1%	-4.4%	-4.4%	32.2	28.1	Silver Spot Price
US T-Bill	0.0%	0.0%	0.0%			3-month T-bill

All returns are estimates through March 28, 2013. Return numbers are inclusive of dividends.
High and Low columns reflect closing prices from the period 1-01-2013 to 03-28-2013 for the commensurate Index, exchange traded fund or spot price.

Chuck Gibson: Yes, that's a good way of putting it.

Catherine: Tell us about the first quarter. What happened?

Chuck: Well, let's pull up Chart 1 and take a look at that first. As you can see, all major U.S. stock markets — the Dow, the S&P 500, and the Russell Small Caps — had banner quarters. All experienced double-digit gains. EFAA, which is Europe, Far East, Australia, and Asia — had a good quarter. It was up 3.7% while the emerging markets were down almost the same amount.

The U.S. Aggregate Bond Index was essentially flat, while junk bonds in this era of investors looking for yield kept chugging along rising 2%. What has been a common theme of late, unfortunately: precious metals took it on the chin. Gold was down 3.7%, and silver lost 4.4%.

Catherine: Right — this is a significant divergence of precious metals from the equity markets.

Chuck: Yes.

Catherine: Commodities are not trading like the other risk assets. We're really seeing a divergence.

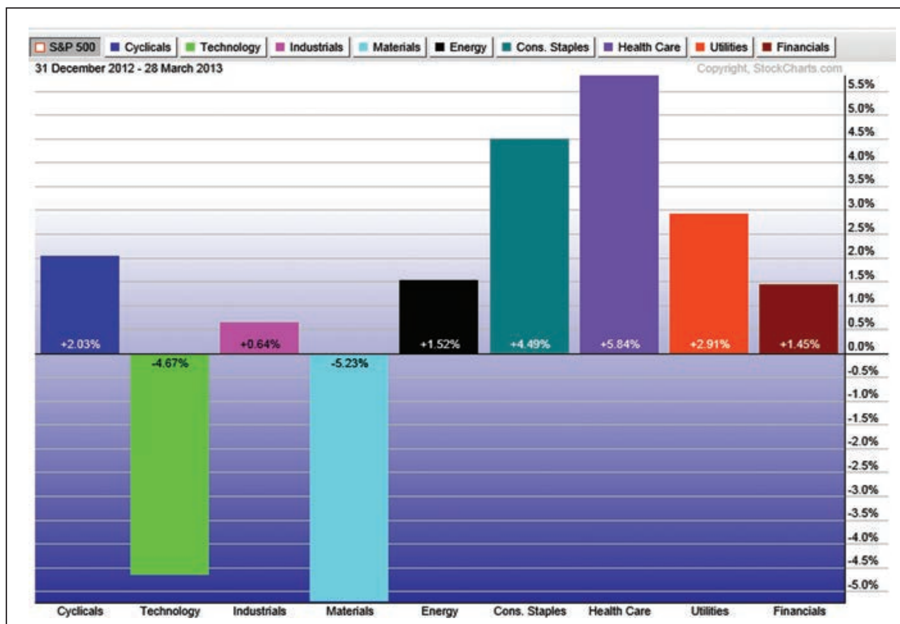
Chuck: Yes. We're going to bring that up further down as we get into the detail. That is one of the things that's been — I won't say it's bothering me, but we're watching it real closely.

All major U.S. stock markets had banner quarters.

Precious metals took it on the chin.

U.S. Sector Review

Chuck: If we turn to Chart 2, here we're going to drill down to the sector



level. We can see that health care, utilities, consumer cyclical and staples were the clear winners. They were all up over 2% while the industrials, energy and financials all posted smaller gains. But interestingly, you've got technology and materials, which lag big-time with pretty large losses.

Catherine: When I first saw this chart, it stunned me. If you look at the different sectors — and this is because of the way the analysis is calculated — no sector did as well as the overall market. More importantly, if you look at the things that really give an economy muscle, that really speak to the economy getting stronger, they're down. The things that are deeply dependent on government subsidy or do well because there's inelastic demand, the prices can get rolled through to consumers, they're doing well.

When I looked at this chart, it surprised me because it maps out a picture of an economy that is not as strong as we're certainly hearing in the corporate media.

Chuck: Yes. We're going to talk about this a little bit further down, too. I immediately question, "Is this just a one-time quarterly anomaly, or is this the new mode that we're in?"

Catherine: I pray it's just an anomaly.

World Stock Market Review

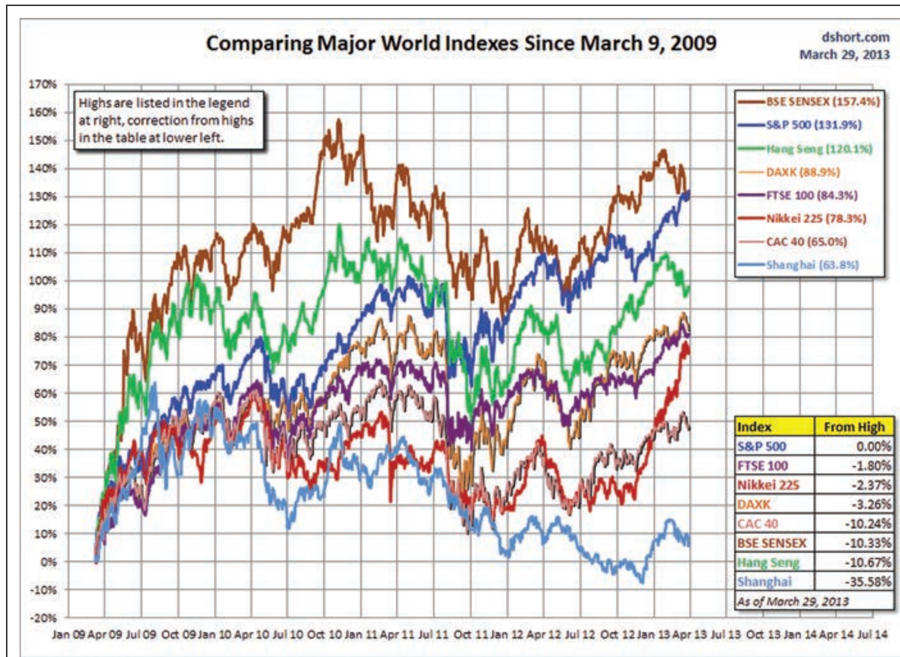
Chuck: Yes — all right, let's go on to Chart 3. What we're looking at in the first column is a listing of all the world stock markets. The second column is their first quarter returns. The third column shows the three-year performance. Venezuela, Japan, Argentina and the Philippines were the top performers. They all gained more than 17 percent, which for a quarter that's huge. We've got the Czech Republic, Italy, Egypt, Poland and Russia bringing up the rear. They all lost about 4%.

All the markets around the world had pretty good quarters in terms of gains.

International Stock Indexes Q1 2013 Stock Market Returns

Index (Region/Country)	Q1 2013 % chg	3-yr % chg
Asia Pacific		
S & P/ASX 200 (Australia)	6.8	0.5
Shanghai Composite (China)	-1.4	-10.5
Hang Seng (Hong Kong)	-1.6	1.9
Bombay Sensex (India)	-3.0	2.2
Jakarta Composite (Indonesia)	14.5	20.7
Nikkei Stock Avg (Japan)	19.3	4.1
Kuala Lumpur Composite (Malaysia)	-1.0	8.2
NZSX-50 (New Zealand)	8.8	10.9
KSE 100 (Pakistan)	6.7	21.5
Manila Composite (Philippines)	17.8	29.1
Straits Times (Singapore)	4.5	4.4
Kospi (South Korea)	0.4	5.8
Colombo Stock Exchange (Sri Lanka)	1.6	15.0
Weighted (Taiwan)	2.8	-0.1
SET (Thailand)	12.2	26.5
Europe		
ATX (Austria)	-2.0	-3.7
Bel-20 (Belgium)	4.7	-0.8
PX 50 (Czech Republic)	-7.3	-7.4
OMX Copenhagen (Denmark)	8.0	10.8
OMX Helsinki (Finland)	5.8	-5.9
CAC 40 (France)	2.5	-2.2
DAX (Germany)	2.4	8.4
BUX (Hungary)	-1.7	-10.2
FTSE MIB (Italy)	-5.7	-12.7
AEX (Netherlands)	1.6	0.4
All-Shares (Norway)	5.7	7.2
WIG (Poland)	-4.9	2.1
PSI 20 (Portugal)	3.0	-10.4
RTS Index (Russia)	-4.4	-2.0
IBEX 35 (Spain)	-3.0	-10.6
SX All Share (Sweden)	9.1	4.8
Swiss Market (Switzerland)	14.5	4.5
Istanbul National 100 (Turkey)	9.8	14.9
FTSE 100 (U.K.)	8.7	4.0
Americas		
Merval (Argentina)	18.4	12.1
S & P/TSX Comp (Canada)	2.5	2.2
Santiago IPSA (Chile)	2.6	0.5
IPC All-Share (Mexico)	0.8	10.0
SP 500 (US)	10.0	34.2
Caracas General (Venezuela)	31.5	119.8
Other Countries		
CASE 30 (Egypt)	-5.1	-8.9
Tel Aviv (Israel)	4.4	0.1
Johannesburg All Share (South Africa)	1.6	11.7

Three year percent change is annualized.



Index	From High
S&P 500	0.00%
FTSE 100	-1.80%
Nikkei 225	-2.37%
DAXK	-3.26%
CAC 40	-10.24%
BSE SENSEX	-10.33%
Hang Seng	-10.67%
Shanghai	-35.58%
As of March 29, 2013	

Chuck: So Chart 4 shows the major world markets and how they fared since the 2009 crisis. You can see from the top right legend there that the U.S., India and Hong Kong have all doubled in price. The Chinese stocks, which have been the worst performer, were still up an impressive 64 percent since then. The bottom right legend shows how far away each is from their all-time highs. As of the date of this chart, it was the U.S. markets that were the only ones to have made a new high. I think since then last week, England's FTSE hit a new high.

Catherine: I look at these numbers, and to me they're flat. In other words, they're flat from their high. All we've done is get back to where we were. If you look at them from the bottom in 2009, they look much better than if you look at them from the last high.

Chuck: Yes, they're quite impressive. The other thing is what would they look like if you did it on an inflation-based adjustment?

Catherine: Right — so we should explain what that means. When we look at an index in any market, we're generally looking at a nominal value. So if the value of the currency that it's priced in diminishes over time, it can look like things are going up when in fact your purchasing power is going down.

Chuck: Exactly. You have two variables. One is the amount that the index actually rises, and then how much it rose when adjusted for inflation. That's where the problem comes in because do you use the government's, or do you use something that's more realistic? So it makes it very difficult to do that calculation because if you use the government's, one tends to just ignore it

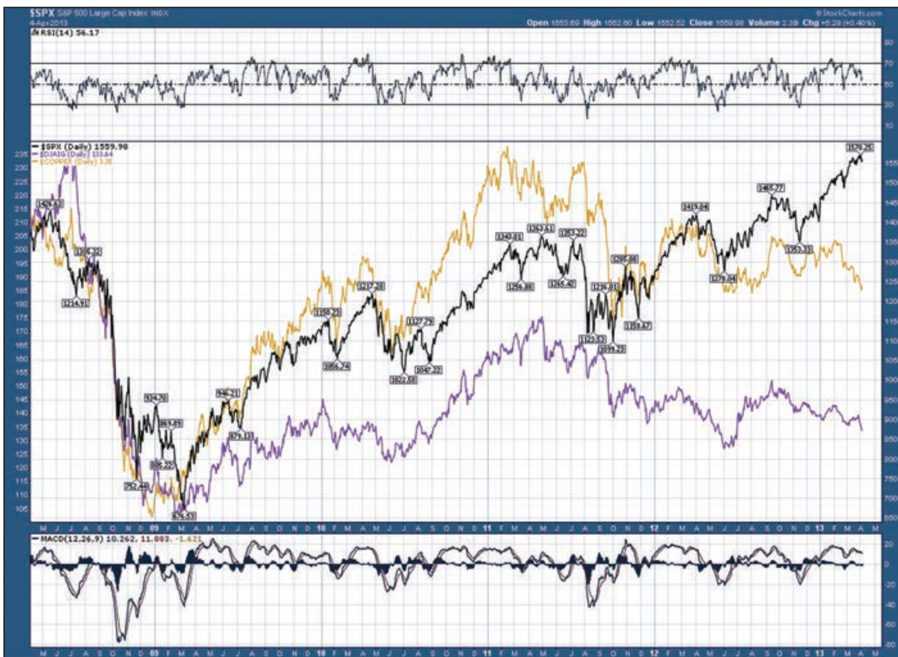
If the value of the currency that it's priced in diminishes over time, it can look like things are going up when in fact your purchasing power is going down.

and say, "It's not real because we don't believe the data that's being presented to us."

Catherine: Looking at equity market indexes always makes me nervous because there can be so much going on inside of it. You're always hearing me say, "There's a new world being born, and there's a world dying." Often when you track an index, you're getting an average of both of those worlds. That's why I like to look at charts that help look inside and see the different sectors and what's going on inside the big "Cuisinart" average.

Market Oddities

Anomaly #1: Copper and Commodities



Chuck: That actually leads me into the next section. There are three things that really jumped out at me in this last quarter. They're oddities, so what I'm going to do is present them here. So let's take a look at Chart 5. The first oddity is really the divergence between stocks and commodities.

If you look at the chart, it goes back to the top of 2008 before the market started selling off hard. The black line, for reference, is the S&P 500. The gold line is copper. The purple line represents a commodity index. In that commodity index are 19 physical commodity futures. So they're futures contracts. And those components consist of things within energy, metals, grains, livestocks and things called the soft commodities, such as orange juice and coffee. It's really supposed to represent a basket of commodities.

If you look at recent history — and this is what I'm talking about is from the 2008 level — it's showing that both copper and commodities track pretty well against the S&P. They don't necessarily move the same amount, but they have been moving in the same direction.

Catherine: Right.

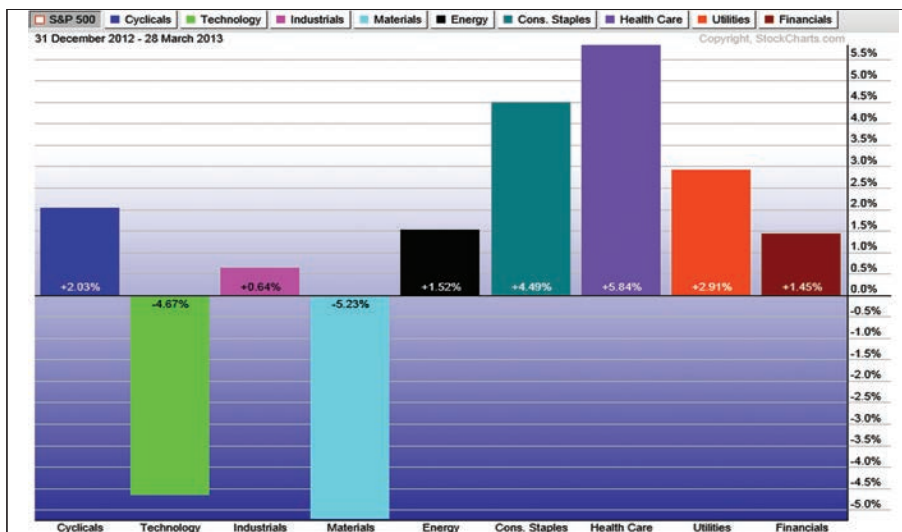
Chuck: What you see from the chart is that sometime mid last year, about the time the market really took off on a tear, both commodities and copper decoupled with the stock market. Since then, they've moved sideways while stocks have pushed strongly higher. And here's the thing. This is the part that's the oddity: commodities, and especially copper, are viewed as proxies to the strength in the economy. The stock market is telling us that the economy is doing very well, at least well enough to return record profits, yet commodities aren't buying into the story.

So if the economy is strong enough to lift equities to new highs, why aren't copper and commodities following along? Somebody has to be wrong, and it's either stocks need to fall or commodities and copper need to catch up. I hate to say this. Maybe this is a new paradigm when we're decoupling for some extended period, because that's happened in the past. I don't know, but this is something that I continue to follow closely.

Catherine: Right — this is one of the reasons I think that the budget talks both in Europe and here are so sensitive. If you look at the sectors that are doing well, they're directly or indirectly dependent on a lot of government subsidy. There's going to be even more pressure on the legislators both here and in Europe because the markets are going to be much more dependent on those cash flows.

Either stocks need to fall or copper and commodities need to catch up.

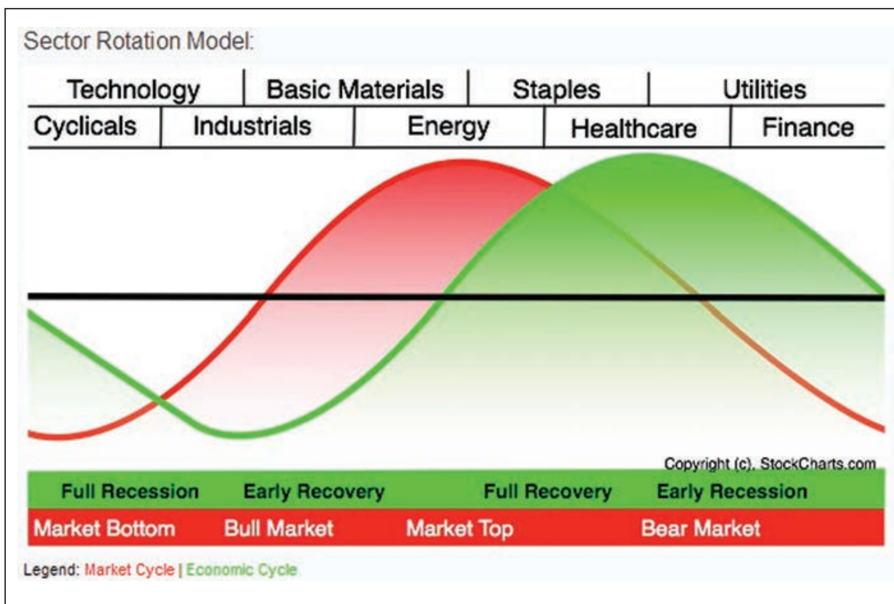
Anomaly #2: Sector and Cycle Rotation



Chuck: Exactly. Well, that leads me to the next section, which is the sector analysis anomaly. Let's go to Chart 6. This is the same chart I showed above, but I wanted to drill down into the details a little bit. So what we saw this past quarter was a rotation out of those more aggressive sectors that took us to historic highs, like technology, and into the more defensive sectors. So is the market picking up on something here that's important on the horizon, or is this just a rotational breather waiting for the next leg up?

I don't know what it is, but don't get me wrong; the daily charts for the U.S. broad market indexes remain intact and still very bullish we can figure. But this divergence is just reinforcing my cautious short-term position here.

There's no question going forward that these defensive sectors can still push this market higher. But if there's anything I've learned in my market studies and experience is that towards the end of a bull market, it's almost always the case that the defensive sectors are what tend to lead.



Chuck: I want to show more support of that argument. Let's move to Chart 7. All right — so this chart is a little bit busy, but it does help confirm the concerns that I raise above. So last quarter, we talked about the long-term economic secular cycles. The data in this chart is based upon the known shorter-term four-year economic and stock market cycles. At the top of the chart, there are different market sectors listed, such as technology, industrials, energy, healthcare, etc.

Below them are two sets of cycles representing the stock market cycle, which is in red, and the economic cycle in green. If you remember what our leading sectors were last quarter — they were healthcare, consumer staples and utilities — now let's find those sectors at the top of the chart, and what you see is

they're over there up on the right-hand side. They're all bunched together. Now, draw an imaginary line from where that intersection is, and follow it straight down to where it intersects the red and green cycles.

So if you look, the economic cycle tells us we have made a full recovery, and we are in the early stages of a recession. The stock market cycle says we have topped out, and we should be at the beginning stages of a bear market. So this is one more reason for our cautious short-term equity stance.

Catherine: Right.

Anomaly #3: The Global Market

World Market	Q1 2013 return
Japanese Nikkei	19.27%
Dow Jones Industrials	11.25%
S&P 500	10.03%
London FTSE	8.71%
US Nasdaq	8.21%
Canada TSX	2.54%
French CAC	2.48%
German DAX	2.02%
Dutch AEX	1.57%
South Korea	-0.18%
Shanghai	-1.43%
Hong Kong	-1.58%
India	-3.04%

Chuck: Let's just jump right into the final and third anomaly, which is taking a look at the global markets. In Chart 8 I've listed the top 13 largest global stock markets and their returns over the first quarter of 2013. I have them ranked in order of quarterly gain. So as you can see, I've divided them up. They kind of neatly fit into three sections. The top group had a stellar first

quarter. The second tier, while up moderately, lagged the top five. And then finally bringing up the rear, the final tier, they all had negative returns. So let's drill down one more level and first take a look at the top five.

So in the top group, I had listed five markets, but there's really only three there because three of the five are U.S. markets: they're the Dow, the S&P and the NASDAQ. So I just count that as one. And the one that stands out in that list is that it's the Japanese stock market: it had almost a 20 percent gain for the first quarter. And below the Nikkei comes in the three major U.S. indices and then split by the London FTSE. So if you notice all of these markets are nations which have two things in common: they have full control over their central banks, which in turn control both interest rates and currency creation, and all these banks are presently involved in huge money-printing efforts via quantitative easing.

Additionally, they are all-promising or continue to increase their efforts in printing, and this money has to go somewhere. It makes sense that at least some portion of it is going to find a home in the stock markets.

Catherine: Right.

Chuck: Let's look at the middle group. This group consists mostly from the core of Europe. The one exception, of course, is Canada. But Canada, like the European nations, has not yet embarked on outright quantitative easing. As such, none of these countries' stock markets are really in bubble territory — unlike the first group.

Catherine: Right.

Chuck: In Germany and Holland — they're trying to impose fiscal and financial discipline in the EU countries with no control over their government or their taxpayers. They're showing the discipline while most of the rest of Europe is not doing so much. Finally, let's close out discussion with the bottom tier, and you'll notice how all of these countries come from Asia. The contrast between these four in this bottom and Japan, which is in the top list, in my mind, could hardly be greater.

While the Japanese market was up almost 20 percent for the first three months, all the countries in the bottom group had negative returns. This is just a great example of the dislocation of real versus paper, of construction versus consumption, of massive debt versus fiscal management, and of a dying middle class versus structurally positive demographics.

Catherine: So the more financially and economically responsible you are, the worse you did.

Chuck: Unfortunately, that's exactly the way it looks, at least for Q1.

The more financially and economically responsible you are, the worse you did.

Catherine: Right.

Chuck: Who said that there's no value in printing money!

Catherine: Right, right.

Chuck: This is why it baffles me.

Second Presidential Term Performance

Chuck: Let's move on to the final chart in Section 1 of our outline. This is one that I know you like.

Catherine: I love this chart. I was — this chart really surprised me.

DJIA Performance During Re-Elected Presidents Second Terms: 1900 - 2012

		DJIA Performance (%)					
		1st Term	2nd Term				
President	Political Party	All 4 Years	1st Year	2nd Year	3rd Year	4th Year	Entire Term
Wilson	Democrat	15.1	-15.6	8.4	7.1	-18.1	-19.8
FDR	Democrat	241.8	-29.3	14.9	-2.4	-11.4	-29.8
Eisenhower	Republican	66.4	-7.0	34.1	9.8	-3.0	32.9
Nixon	Republican	9.7	-16.6	-9.1			-24.3
Reagan	Republican	26.4	25.2	35.1	-5.4	13.8	82.1
Clinton	Democrat	109.9	13.5	20.5	25.5	-9.7	55.0
Bush	Republican	-0.4	3.2	15.5	-3.7	-34.3	-24.6
Obama	Democrat	55.2					
Average		**67.0**	**-3.8**	**17.0**	**5.1**	**-10.4**	**10.2**
Percent of Time Positive		**85.7**	**42.9**	**85.7**	**50.0**	**16.7**	**42.9**

Chuck: Chart 9 shows the Dow Jones performance during the reelected presidential second terms. It shows how the stock market did during their second term split up by the first year, their second year, their third year and their final year. Then it takes a look at the entire — during their entire term of the second term.

What I find interesting is that on average, the first-year performance of the market was down 3.8% on average, but the thing was is that ever since Reagan, there's never been a down year — well, all those down years happened prior to Reagan. Anything since Reagan has been positive in the first year.

Catherine: That is fascinating. I can't come up with a politically logical explanation.

Chuck: Well, neither can I. I thought it was going to be before I actually looked at the data. I saw that it was negative. It kind of makes sense the first year you're going to have a down year. But it's clearly not consistently negative, and it hasn't been negative since Nixon.

Catherine: Although, I will say this: if you look at the internal financial controls within the federal government, they've been steadily deteriorating. The Reagan administration was very instrumental in weakening them. The subse-

quent administrations were as well, so that is one possible contributor, but I can't imagine it's everything.

Chuck: Well, it was, again, a shock to me. I'm not sure I could draw a firm conclusion from it, but it was interesting.

Catherine: I said that there are a lot of big questions as to which way things go. To me one of the big questions is for five or more decades, since World War II, we've had the federal government borrow and spend, borrow and spend, borrow and spend, and that money has spilled over into all sectors, but certainly into corporate profits one way or another. Then for two decades we've had very liberal monetary policy, and that money spilled over. The question is if those policies have to change, and certainly fiscal policies do have to change, what's that going to — how's that going to spill back over?

Chuck: Exactly.

Catherine: It's been such a big platform for all the markets, bond and equities. What happens when that platform gets reengineered? I think most of the market participants who are functioning have been functioning on that platform so long they think it's natural — the sun comes up and all this money's around. I don't think anybody's ready for the paradigm shift, frankly.

Chuck: Well, and I know that wasn't where we wanted to go with this discussion, but my question to you would be because of that, what is the probability of that happening?

Catherine: Well, let's jump back to the chart before this where we looked at the three markets or the three baskets of markets.

The top markets that are doing so well are literally reflecting an addiction to central bank money and treasury money. The basket at the bottom — South Korea, Shanghai, Hong Kong, India — are used to struggling without these massive infusions of financial methadone. We see this bifurcation. We can see the pressures — if you're a government leader, and you can get these kind of results in the financial market by injecting another round of that financial methadone, the pressure on you to do so is enormous. At some point it becomes impossible not to.

What we're facing as a society is as follows. Think of all the financial assets as an upside-down pyramid sitting on top of the different governmental budgets. We've now created this tornado of derivatives and bonds and stocks which need their next hit, or else their prices are going to have to adjust. The challenge with that is we're running the economy to keep the value of the paper up instead of running the economy to build the most economic muscle over the long term.

Since World War II, we've had the federal government borrow and spend, borrow and spend, borrow and spend, and that money has spilled over into all sectors.

Part of it is the short term versus long term. The question as a matter of process is, "How do you create a political process that will allow you to build a strong economy as opposed to keep a speculative paper game going?" There needs to be reconciliation between our securitization of the world and the real world. That's why we keep talking about fundamentals and tangibles. At some point if you strip your real economy to keep the paper game going, we all know where that goes.

That's one of the big questions you and I keep asking, "How do we make sure that the people that we're responsible to serve are protected in that transition?" because one way or another, it's happening.

Chuck: Yes — and it's been painful. It's going to be those tangibles — those real things that are going to survive. Unfortunately, of late, it's seems just the opposite.

Catherine: Well, to me, what a savvy investor can do is if you're interested in investing in the fundamentals, we know in all of these economies there are really great companies.

You are the person who introduced me to your concept of "gems." We struggle with, "How do you describe what a gem is?" It's one of those things where you know it when you see it. Within all these different sectors, there are companies that are real gems that are coming up with solutions for the things we need to build the future. If you're a savvy investor, what you can do is not swing around like a fruit fly with money printing, but focus on where are those gems.

There is one surgical system company I'm always using as an example. From 2003 to I think it was 2012, silver was up 800%, gold was up 500%, and the surgical system company was up 4,200 percent!

So I think sometimes when these kinds of anomalies happen between what's real and what's not, if you can focus on what's real, you can find those gems and take advantage of the fact that they're down. But you need a strong stomach.

Chuck: That's exactly what I was going to say. It does test your mettle. There's no question.

Is this bubble ready to pop?

PART II: Bonds – Is this Bubble Ready to Pop?

Chuck: All right — you want to jump right into the second part?

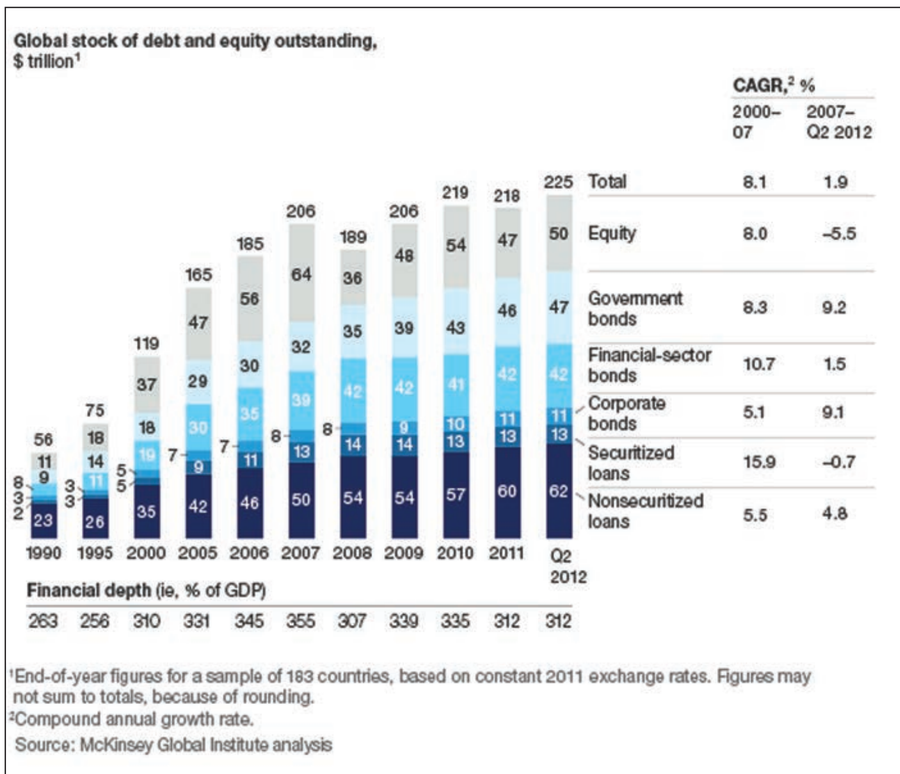
Catherine: Yes, sir.

Chuck: All right — so you know, for those that were familiar, last quarter we

spent the second half of our discussion on the headwinds facing equities. So this quarter, in an attempt to be fair and balanced — because you know that's me: Mr. Fair-and-Balanced — I want to present the other side. Looking beyond the inherent volatility in equities, I strongly believe that they will be the best investment vehicles for the future for those with long-term investment horizons. I see this only because of the fact that it will be companies and entrepreneurs or individuals, not governments, that are going to provide the solutions for both human and our planetary needs.

So if we're going to thrive and flourish, it's exactly what you just said: businesses will need to be front and center.

Catherine: Right. Getting our hands around the beast — the worldwide size of asset classes



Chuck: All right — let's jump right into Chart 10. This is a chart from McKinsey that measures the size of global financial assets. McKinsey did a study where the estimated the size of all global financial assets. They broke them down into six categories. From the top to the bottom you can see there were non-securitized loans, securitized loans, corporate bonds, financial sector bonds, government bonds and equities. As you can see in the adjacent table to the right, debt issuance has grown substantially in all the areas except for securitized loans, which have been essentially flat since 2007.

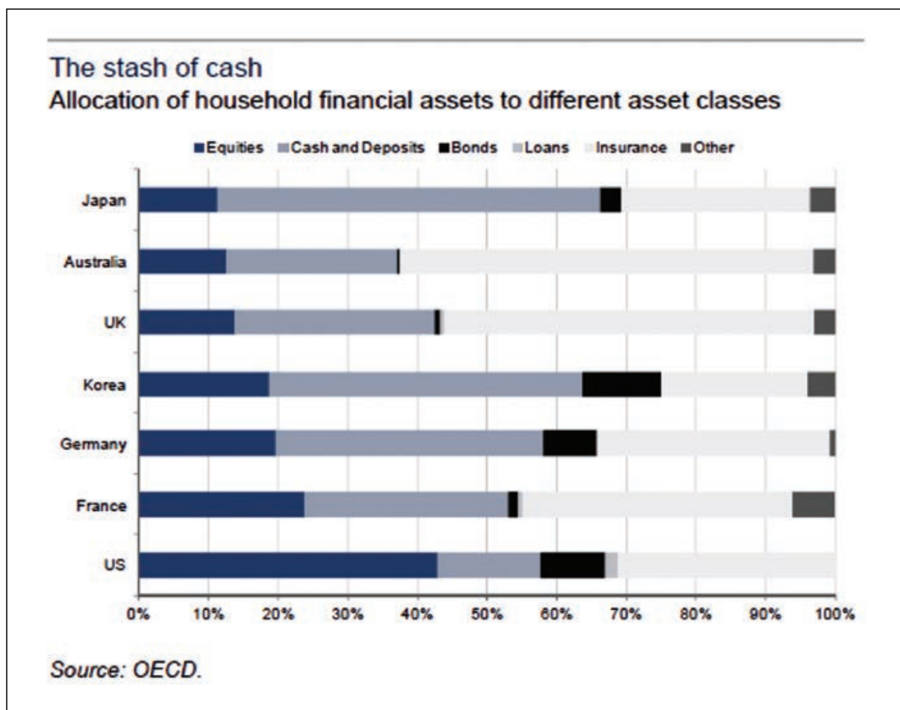
it will be companies and entrepreneurs or individuals, not governments, that are going to provide the solutions for both human and our planetary needs.

You notice that government bonds have increased the fastest. They're in a virtual tie with corporate bonds, which grew over a 9% per year compound annual growth rate. What I find most interesting in all this data is at that same period of time, equities actually shrunk by more than 5% a year.

Catherine: If you look at our model for how we're functioning economically, this model is very scary. When people own equity in something, they have a vested interest in seeing it work. When they are swimming in government guarantees and government debt, you know, they don't necessarily care if it works; they think they're protected. I said when Cyprus happened, "We've really rung the bell on that model."

It's a wake-up call. If the overall economy doesn't work, then maybe your government guarantees don't mean so much. To me, we've got to get into an equity model. We can't keep swimming in a sea of government debt. It's just not going to work.

We can't keep swimming in a sea of government debt. It's just not going to work.



Chuck: Yes — I agree with you. Well, let's take a look at Chart 11. So for me, this was probably one of the most surprising sets of data just because of the fact that in my ignorance I assumed that most households around the world were going to hold financial assets similar to how we do here in the U.S. In this chart, it's very clear that they don't. Real briefly, the blue line are the equities, and the light blue are cash and deposits, and the black portion are bonds, and then you've got loans, insurance and other.

What you can see here is that the United States owns roughly 40-plus percent

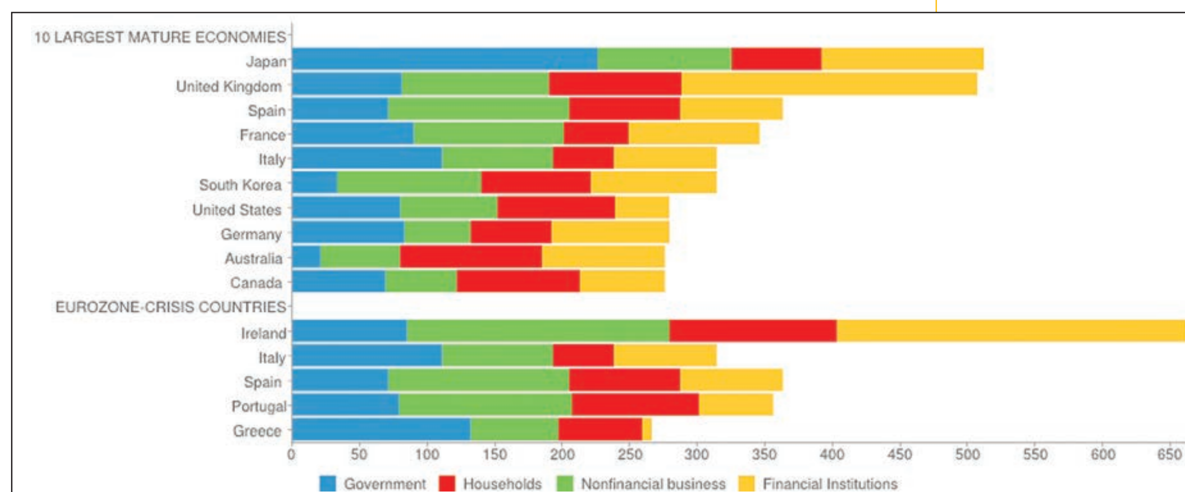
of their entire financial assets in equities where the next closest country is approximately half of that. Everybody is much, much lower than that. This was so surprising that all it's really going to take is for people to realize what you just said, and that is that the movement — all it would take is a small movement into equities to be able to give a nice boost to the equity market going forward.

Catherine: Right — it's a very big swing globally. If the U.S. holds where it is and other countries as they, particularly in the emerging markets, start to increase anywhere close to us, it's an enormous swing.

Chuck: Yes. I don't know if this trend is going to be the same, but you consider that equities have been declining at a five percent per year basis, that's going to create a supply-and-demand type of imbalance.

Catherine: Right.

Bonds – An Overview of the Bond Markets



Chuck: Let's jump right into Chart 12. This is a snapshot of total global debt as a percentage of GDP. This was as of 2011. So in the upper half of the chart, it shows information on the world's ten largest developed countries. And the bottom shows the world — some PIG countries, and as you can see they slice the data up into smaller pieces out by government debt, which is in blue, and then household debt there is in red, nonfinancial debt is in green, and finally financial institution debt is shown there in yellow. This was quite shocking to me when you look at it as a percentage of GDP. It made me think of a horse race.

"Here we've got Japan coming around the corner first, followed by United Kingdom, closely followed by Spain." This amazing to me that the world is in this kind of situation.

Catherine: Well, it's not so amazing to me since I've spent many decades struggling in the trenches of government service or government contracting trying to deal with it. I would say it's unpleasant that we're here. I think the thing that is scary about this chart is if you look at the unfunded liabilities, which are not included in these numbers, essentially they reflect an aging population. So the subscribers are always listening to me quote Neil Howe, who said, "We have $100 trillion of unfunded liabilities. How's that supposed to work out?"

If you look at the debt levels now versus the debt levels if we try and deal with those unfunded liabilities, we're clearly coming into a major turn in all sorts of different policies and situations. It's a pretty amazing situation to be in. As I said, there are big questions, and to me this is one of the biggest questions. How do these unfunded liabilities get worked out? How do we go from having this much debt? I said the other night on the *Solari Report*, we need a planetary debt-for-equity swap.

And you kind of wonder how that's going to happen. And I go back to my favorite quote from Tina Turner. "Are we going to do this nice or rough?"

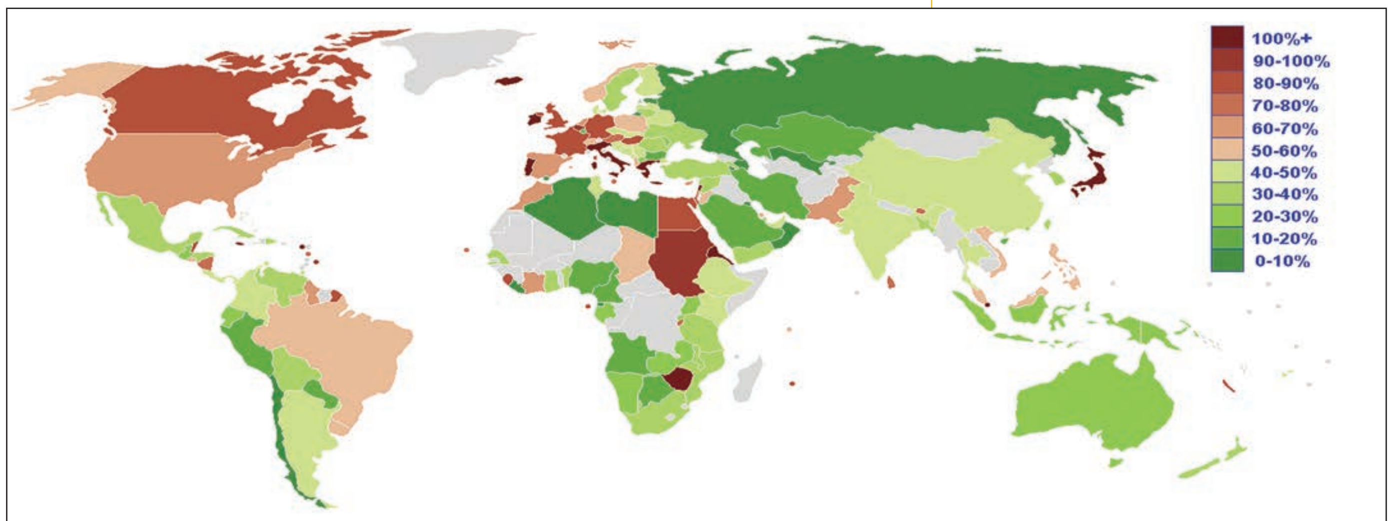
"Are we going to do this nice or rough?"
—Tina Turner

Chuck: Yes.

Catherine: But it's going to happen one way or the other.

Chuck: Yes, it seems like you're using that quote more and more frequently.

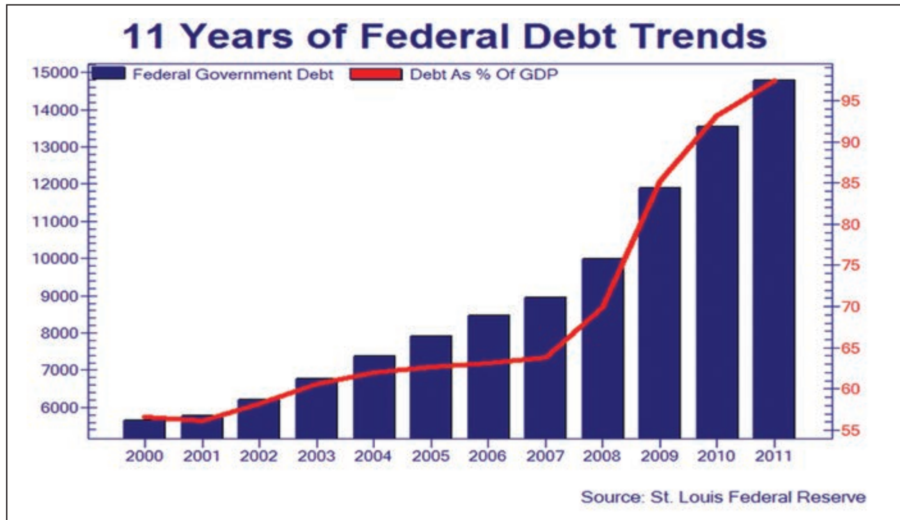
Catherine: Yes, I am!



Chuck: All right – let's move on to Chart 13. The last chart was one of the largest developed countries. So I wanted to take a look at the world in perspective, and this chart give us a global perspective of the problem. The countries that are in green are those countries with the lowest debt ratios. The darker the green, the lower the rates. Those in red have the highest debt ra-

tios; and, of course, the darker the red, the worst the problem. So please note though that this chart takes into account only public debt, whereas the other one was a little bit different. It included a little bit more.

Catherine: Right — so what we see are we have economies with great long-term growth that have less debt. Then we have the mature economies that are slowing down and have tremendous amounts of debt.



Chuck: All right — want to move to Chart 14?

Catherine: This one is one of my favorites.

Chuck: Yes — favorite in an interesting way. As it states on the header, this chart is one of the growth of U.S. federal debt since the year 2000 through 2011. What I wanted to do by showing this data is to focus on the rate of growth, not necessarily the actual percentage. While the debt percentages are astonishing, to me what's more incredible is the rate of growth. So you could see there that in 2000 we started on this hockey-stick style ramp that should make anybody looking at this chart very queasy, unless you're a Fed member.

I want to point out that for those who might be following very closely that the reported numbers on this chart, again, might vary slightly from the other ones that are presented. That's partially due to either different data sources and/or time periods. But what we're trying to do is get the magnitude and the direction, not necessarily the exact numbers.

Catherine: One of the things that struck me about this is the increase in the nominal amount of debt between 2000 and 2011. We had a study come out from Harvard recently. It was up on the blog about two weeks ago saying that the total cost of the wars in Iraq and Afghanistan were $4 trillion to $6 trillion. So if you take the money that went missing in 2000, 2001, 2002, which is $4 trillion that we know of, you take the $4 trillion to $6 trillion for Iraq

and Afghanistan, and then you take the portion of the bailout that was on budget — that explains the entire increase.

Now, if you have tremendous pressure on employment and income that will also lower tax flows into the government at the same time. Whether it's the population that's aging or the sort of reengineering of global labor with globalization, you have further added to this systemic deficit. We are watching a skyrocketing of household dependency on government subsidies. That's a dynamic that can just shoot this line continually up, up, up. For all of us looking at it, the question is, "Well, what's the end game?"

Chuck: Right.

Catherine: How exactly is this supposed to work? I wrote an article called "Coming Clean Beyond the Fiscal Cliff" at the beginning of the year so that people who were interested could take deeper look and see why the Congress has such a challenge ahead of them. Reconciling these different issues is reminds me of the quote from the head of Luxembourg, "We know what we need to do; we just don't know how to be reelected after we do it."

Chuck: Yes! It's really hard and challenging for those that are investing because if it does turn out to anything close to where we all think it might end, it's really going to test the markets.

Catherine: I look at this chart, Chuck, and it is my nature to want to stick with the primary trends. So I the excellence of the fundamentals in the emerging markets, and that's where I want to align. Then you get into a quarter where everything that is flying up in the stock market is something that when you look at this chart you say, "Oh, my God! The fundamentals are so dreadful, you know, it's scary to put money in it, let alone at these highs."

You know, the worst fundamentals in the world are up 20 percent this quarter. I mean, how do you reconcile that? So the risk of going into those things when they're flying is much greater than it looks.

Chuck: Yes, I think it helps us make the argument for why we're cautious at this point in time.

Chuck: All right—let's take a look at Chart 15. And for those that are aware —

Catherine: I call this chart "The End of the World as We Know It!"

Chuck: Well, this chart is a historical look at the 30-year U.S. Treasury bond pricing. From a cursory glance, it confirms that U.S. treasuries have been in one of the longest running capital bull markets that we can think of. So therefore, bond yields, which are the inverse price, have of course been in one of the longest bear markets. So just for a reference point, 30-year yields in 1981 were at 14 percent, and today they're just slightly above 3 percent. So what is clear, though, that this bull market is very long in the tooth.

As we all know, bulls and bears are eventually moved out to pasture where they eventually die. So the question is, "when will we see the first crack in rates appear?" Because that is going to be — because of the size of the bond market — a potential major shift.

Catherine: I told my story in February. I was at Morningstar and discovered that the six-month return on long Treasury bond funds had been negative (7.6)%.

Chuck: Yes.

Catherine: The Treasury market had been under pressure. If you're all the governments around the world trying to finance this enormous government debt — even a bad quarter or a bad six months — that's pretty scary. This entire tornado is dependent on the government budgets being able to borrow more money and send more money up the tornado. So you've got this tiny little point that spreads out into this huge upside-down pyramid. And if that starts to get shaky, you know, the whole pyramid gets shaky.

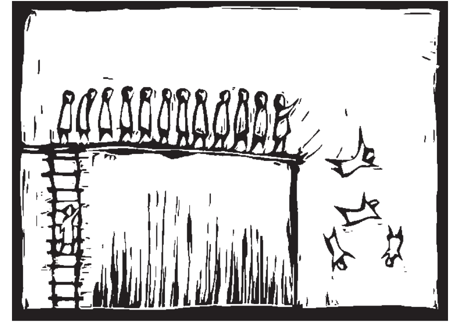
One of my favorite quotes is James Carville saying, "When I die, I want to come back as the bond market: you can intimidate everybody!" There are great stories at the beginning of the Clinton administration of Rubin, his Secretary of Treasury, killing every idea that everybody wanted to do saying,

"The End of the World as We Know It!"

"The bond market wouldn't like it." That's because the whole game is so dependent on the bond market, and we've had winds in our sails the whole way.

I think for all of us, the question is, if that turns around, what happens next? Because it's going to reverberate through every aspect of life and every financial market.

Chuck: Yes — what people who haven't been involved in the markets, regardless of which market, what you find is when you have panic you have places that move unbelievably fast. Again, it's not really a market — but just take a look at what Bitcoin did: down 70 percent in 2 days. That's how people react when there's fear and they're afraid something's happening. So while we're moving along down this path of ever-increasing bond prices and lower bond yields, all you do need is that one crack to be able to start the lemmings jumping off the cliff.



While we're moving along down this path of ever-ncreasing bond prices and lower bond yields, all you do need is that one crack to be able to start the lemmings jumping off the cliff.

Catherine: I said that there are big questions before us. One of the biggest questions that you and I struggle with is we've seen governments print more and more money, more and more money, more and more money. And that money is piling up in the bond market. And you watch the central banks, and you think, "How in the world can they keep all that money in the bond market when it's earning nothing?" But they've done it. It piles up, and it piles up, and it piles up, and the question is — it's like a herd of wild horses.

If the herd decides to leave, where are they going to go? Because it's going to go someplace, and it wouldn't surprise me — I mean, Bitcoin — $1 billion is nothing compared to the bond market, but it wouldn't surprise me if you had money saying, "Well, might as well go into Bitcoin.

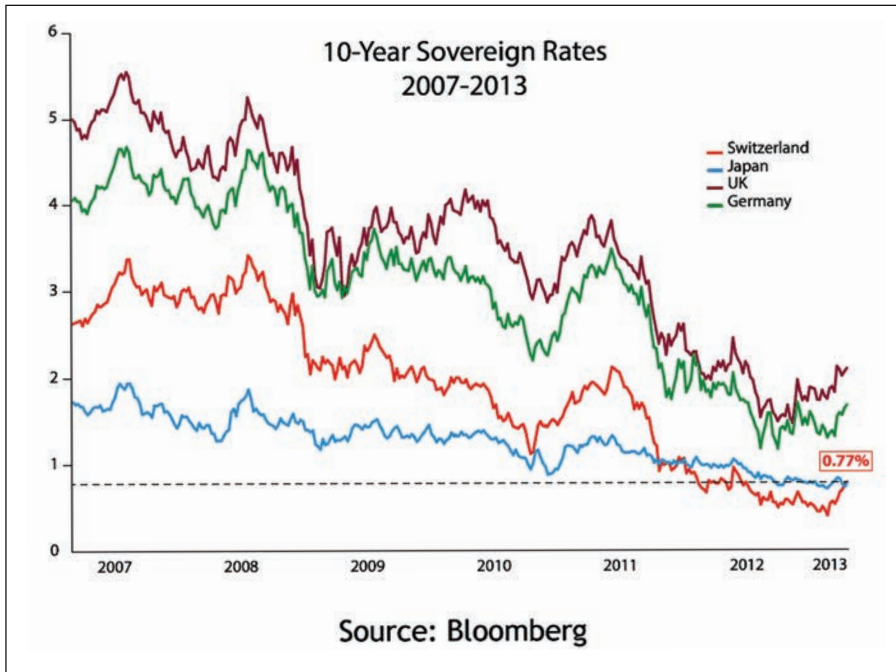
Chuck: Yes, exactly.

Catherine: So the big question is, "Is that money going to go into the equity markets? Is that money going to go into the commodity market? Is that money going to go into real estate? Where is it going to go, because it's got to go someplace?"

Chuck: Right — Well, let's jump onto the next few charts, because that's exactly where I was leading to with that one. We don't know where it's going to go, but it definitely has — it has you wondering, because it will, as you said, reverberate through all the markets.

Catherine: Right.

So the big question is... "Where is that money going to go, because it's got to go someplace?"



Chuck: So let's take a look at Chart 16, which is "Sovereign Debt Yields." Just for reference, because it's not shown there, last week the U.S. bond ten-year Treasury hit a 1.72%. So as a matter of perspective, you can see from this chart that the United States is basically paying the going rate for ten-year sovereign debt as we sit smack dab in the middle of those other developed countries shown there. So as you were alluding to, I see this, and I say, "What's going on?"

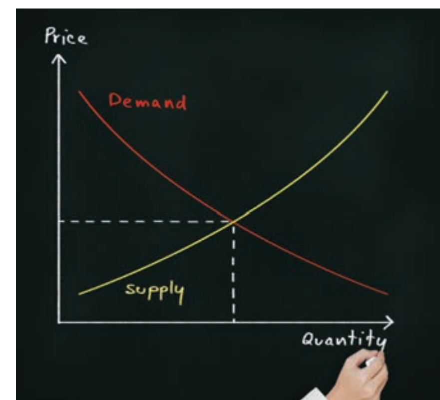
If there's unprecedented printing of money and issuance of sovereign debt, then I automatically think that the laws of economics appear to be violated. You'd expect prices to fall and yields to rise under that scenario. We learned that in beginning economics that when the supply of something gets larger and larger, the price is supposed to go down.

Catherine: Right.

Chuck: But yet in this case, bond prices continue to rise, and they've been rising for 20-plus years. So what's going on? Why is there this dislocation?

Catherine: One of the things that I believe, although I think it's very difficult to prove, let alone document, is that the growth of derivatives have given central bankers and the big banks interest rate swaps and other mechanisms they can use to hold rates down. If you look at the explosion of interest rate swaps during this period, another question is, "How do you keep that going?"

Chuck: Yes, that's a good point. I didn't even think about that, but in my mind, what I immediately ran to was what I'm showing here in Chart 17.



We learned that in beginning economics that when the supply of something gets larger and larger, the price is supposed to go down.

This to me is the explanation for what's going on. The fact is that those that are in control of the debt are monetizing it and thereby keeping control of the supply. So instead of actually making it to the market where market forces and economics would work, the central banks are buying pretty much any and all of government bonds that are not being absorbed into the normal market.

So doing so reduces supply, it creates an artificial demand, which in turn drives prices up and, of course, yields down. So to me this is where the bulk of what's going on and why.

Catherine: One of the things to me that's most remarkable, if you look at the regulatory policies related to banks, there's tremendous pressure on the small banks to not loan and to basically invest back in treasuries. What that is doing is it's cycling the money back to the government instead of the liquidity spilling out on Main Street in a way that would kick up inflation and get that copper price going back up. So you see an explosion of liquidity, but it's like water that is very carefully channeled in certain directions. It's not spilling everywhere.

Chuck: Well, that in addition to the fact that the economy is not quite as robust as it needs to be to be able for people to go out and borrow and take risks.

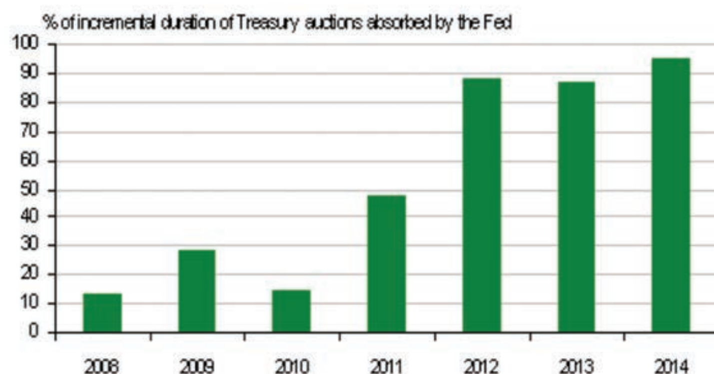
Catherine: Right.

The Federal Reserve's Role In The US Treasury Market

Business Insider

"The Fed is set to absorb almost all of the supply of U.S. Treasury debt this year, just as they did last year. Even a modest reduction in the rate of buying could have a disruptive impact on interest rates and the economy."

—Drew Matus, Senior US Economist at UBS



You see an explosion of liquidity, but it's like water that is very carefully channeled in certain directions. It's not spilling everywhere.

Chuck: All right — let's take a look at Chart 18 because this is a look at where the U.S. Fed's role in the treasury market is. This chart zeroes in on the data within the U.S. It helps me enforce the explanation about the central

bank's balance sheets in my mind. We can see that last year the Fed bought more than 80% of all government-issued debt, and it's on target for doing the same thing this year, and it's projected to be over 90% for next year.

Catherine: That's absolutely astonishing.

Chuck: I mean, but why worry? What can possibly go wrong here, right? The one thing that we do have to worry about is what happens if yields should rise? What do we need to expect?

Catherine: Well, I mean, if it keeps going this way and yields rise, then they're going to be financing 120 percent everywhere.

Rate Rise	Over xx period	Bondholder DD
1.80%	69 Months	-0.36%
2.20%	7 Months	-23.50%
3.00%	35 Months	-22.60%
6.00%	60 Months	-36.20%
4.00%	12 Months	-34.80%

Chuck: Until they can't — yes. Let's take a look at what happens if yields rise, because I think that this is where investors really aren't prepared. Or I hope that they are, but I'm throwing it on the table that because the bond market has been nothing but a bull for 20-plus years that people aren't going to be prepared for this.

Catherine: Let's just mention before we look at this, Chuck, what that means. What that means is in 2008 or 2009, if I'm worried about the equity market being volatile or dropping, I can go to bonds. I can get out of stocks, and I can go to bonds, and bonds are a safe place to be. But I think what we're saying is that's been fine as long as you've had yields trending down. If you're in a world that's different than that, that old safe haven may not work

or may not work as well.

Chuck: Exactly.

Catherine: Right — well, in fact, in 2008-2009, we saw some very high quality bond funds get clocked by very significant percentages.

Chuck: 50 percent!

Catherine: Yes — so if they experienced that, then they know that it's the case. I think generally, we don't appreciate how much volatility we can experience in fixed income this time relative to equities. It's pretty significant.

Chuck: I agree, and that's my biggest concern. I just don't think that most investors yet are prepared. I think they're willing and able to deal with small losses. If and when they turn to large ones, I just don't know how they're going to react.

Catherine: Right — this could be very ugly.

Chuck: The other thing — it's not just investors. Think about the pension funds and the institutional money that's relying on that "safety and stability" that bonds provide for them in their portfolios. Could they really withstand a big loss for three years? What kind of impact would that have on those that are relying on that pension money coming to them through retirement?

Catherine: The bankruptcy in Stockton, California, brings this up. I'm going to talk about it at another time with the subscribers. Essentially, if we should get this kind of turn in the bond market, then suddenly the actuaries at all the state and local pension funds are going to inform the municipalities that they've got to significantly increase their contributions. And then you're talking about a real dynamic throughout the economy, which is going to be very profound.

Chuck: Well, not only increase, but there's the other side of it which might be that they can't meet that increase requirement. Therefore they got to cut off some of the money that they're providing. They got to default on — not default in whole, but default in the amount that they committed to paying in entirety.

Catherine: Right.

Chuck: As a bottom line, I don't think our society today in the United States or our financial model is set up that they could reasonably withstand one of these worst-case scenarios. I do think that this is something we really need to be watching closely. As you said, I think the bottom line is if and when that starts to happen, where is that money going to flow, and what impact is that going to have in other areas. Because the bond market is so large that all it's

going to take is a little trickling into commodities, into precious metals, into equities — wherever it happens to find a home — real estate — those markets are going to potentially take off like a rocket.

Catherine: Can you give us a sense of relative size?

Chuck: Yes — I'm going to go back to Chart 10. I'm just doing a ballpark estimate. So for world global financial assets, it looks like equities make up between 20 and 25% of entire global assets.

Catherine: Well, I'm looking at Q2 2012, you've got $47 trillion in government bonds and $42 trillion in financial sector bonds, and $11 trillion in corporate bonds. Then you've got the securitization — about $170 trillion in fixed income versus $50 trillion in equity.

Chuck: So I think it's $50 trillion over $225 trillion is what it works out to be.

Catherine: Right — so it's four or five times —

Chuck: Yes.

Catherine: — more debt than equity. If only 20 to 25 percent moves over, you double the amount of equity.

Chuck: Yes.

Catherine: That's huge.

Chuck: Investors I think are going to need to be more careful about their fixed income choices.

Catherine: There are two things that can lower the value of a bond: one is a credit problem. So let's say I own a bond in New York City in 1974, and then the city almost goes bankrupt and the quality my rating can drop or the perception of the quality of my credit can drop. If I have bond insurance and the bond insurance company goes belly-up, which we saw in 2009, suddenly it's not a AAA rating anymore. It's something else.

So the credit quality can deteriorate and that can hurt my bond.

The second thing that can happen is interest rates can go up and the value of my bond goes down. There's a wash back. Interest rates go up, and suddenly issuers have more trouble, and so credit deteriorates, too. So there are two things to be concerned about. Both of them can have a dramatic impact on the value of your investment. So we're in an environment where we need to be a lot pickier about credit. We also need to be cognizant that we can have the most wonderful credit in the world, and the interest rates can still swing us one way or the other.

Chuck: Yes, that's a good point. One might automatically think to say,

There are two things that can lower the value of a bond: one is a credit problem.

"Well, maybe I can mitigate some of these risks by going into shorter maturities, which will impact or help impact the size of potential losses that one would take if we had a rise in interest rates. But what you're giving up today is if you go to a short-term — a two-year CD is going to get you 0.2 percent. So you're going to get — you're going to give up — for some safety in the long-term price impact, you're going to give up yield.

Catherine: Right — although, here's what I do have to say. You know, because a lot of times fixed income is a parking lot, if you look at the equity markets and they look as high as they are right now, it's pretty easy to say, "Well, wait — I want to wait before I switch."

Chuck: Right.

Catherine: So staying in bonds can certainly make a lot of sense. And of course, in this environment, if you're conservative, as you and I are, in all things balance. So you may be getting nothing by having money sit in a bank deposit. But it also is great to have cash if you get an extraordinary buying opportunity.

You may be getting nothing by having money sit in a bank deposit. But it also is great to have cash if you get an extraordinary buying opportunity.

Chuck: Absolutely. That goes back to the methodology of buying low, selling high, or at least making sure that you have some dry powder as you get closer to what — like today where we are in the market: at all-time highs.

Catherine: Right.

Chuck: You brought up some really good points that we talked about, which were the impact to — or potential impact to cash.

Catherine: What do you mean?

Chuck: Well, you talked about if regulators happened to proceed with bank failures and without the too-big-to-fail policy, uninsured bank deposits and bondholders could lose some or all of their value.

Catherine: Right — just like we've enjoyed the dropping yields in the bond market, we've enjoyed both the positive and negative effects of the too-big-to-fail policy. We know that the financial sector has expanded far beyond what is healthy for the economy to enjoy in terms of financialization or just financial speculation. So the regulators have been under orders from the time that Dodd Frank passed on to say, "We want you to be able to resolve a bank failure or a troubled bank without too-big-to-fail."

And what does that mean? That means that when that time comes, that bank is going to be put through a process, whether it's bankruptcy or something like bankruptcy where the creditors and the bank depositors who are not insured are going to be written down or swapped into equity. That's going to send a chill throughout the market, because we've been in too-big-to-fail essentially

since the mid '70s. And that will have ramifications running through all the different markets, whether it's bank deposits or money markets or short-term bonds.

When that happens, there's a chill that runs through the whole system. The danger is that you seize up in liquidity. We started to see that, and that's why Paulson was screaming we needed the bailouts because of the concern that the money markets would seize up in a bad way. We have the SEC coming out shortly with new regulations on money markets. One of the things they're grappling with is when they get ready to do this kind of too-big-to-fail — or not-too-big-to-fail kind of resolution, how are the money markets going to handle it?

So we're coming into a world where cash management is also challenging — so not only are you going to have profound changes in the bond market and how it trades. There are going to be profound changes in the cash market and the short-term fixed income markets and how they trade. So you're right! Cash is going to look very different I think in the future than it has in the past, same as bonds.

If you add all the cash that's sitting — there's still remarkable amounts of money on the sideline, and if that money decides to shift into risk assets again, you can have some significant changes.

I'll never forget, and I've mentioned this before on the *Solari Report* — during the Iceland crisis, a reporter was interviewing people coming out of the bank, and a woman said — a young woman was coming out, and she said, "What did you do?" And she said, "I took all my money out of the bank." And she said, "What are you going to use it for?"

And she said, "I'm going to pay my mother's mortgage." And the reporter said, "Why?" And she said, "Well, you know, I know if things are really bad my mom will be there for me. Who knows if the bank will even exist." I said, "Well, people are remembering why we had such a thing as families and communities."

"I know if things are really bad my mom will be there for me. Who knows if the bank will even exist."

Chuck: Yes, it does kind of all fall back to that in the long run, doesn't it?

Catherine: Yes, it does.

Chuck: Well, what we've done here is show that both the potential increase in risk in both cash and fixed income markets, does make you look at those stable companies as quite attractive or potentially quite attractive alternatives.

Catherine: Right.

Chuck: The only problem is the volatility that's inherent in the equity markets that tends to make people shy away from them. But in the long run,

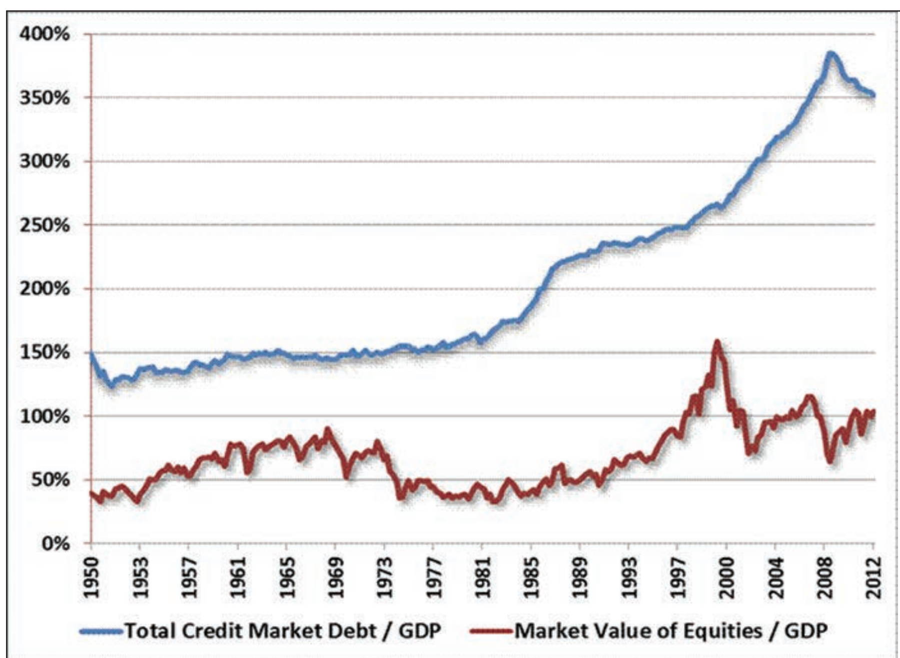
depending upon what happens and how it all plays out, I think what we've done is lay out a potential scenario where fixed income could actually be more or as volatile as equities. So what's the advantage of the fixed income position or the cash position? Because equities at least give you some upsides.

Catherine: The way I feel is if you look across all the different asset categories, whether it's cash, whether it's fixed income, whether it's equities, whether it's commodities — all of them are — we're going into an environment, Chuck, where we have a political model that has increased risk. And what that means is increased risk across the board. So we've been spoiled, and we've been lucky. We've been spoiled, and now we're going to have to go into — we're going into a new world where we're going to have to manage risk in a whole new way. And it is what it is.

Chuck: Yes, I agree. We keep saying this, but I think it comes back to no matter where you're going to go, you're not going to be able to avoid volatility. So it's going to be inherent in everything that we do. You need to accept it, you know. And as one of my best clients says, "You got to put on your big-boy pants and deal with it."

Catherine: I love that expression. That's it for bonds. Let's turn to stocks.

Stocks



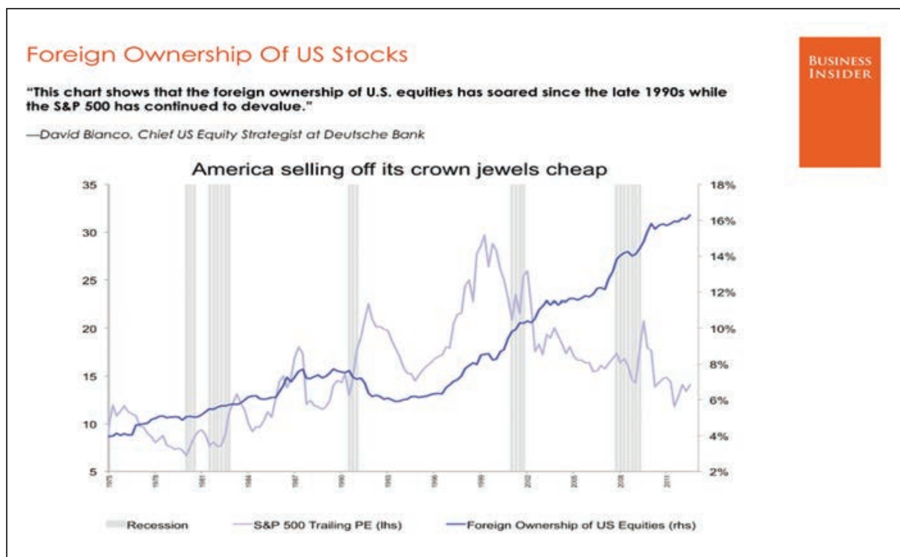
Chuck: So I've presented some pretty decent arguments why one should be more concerned about holding bonds than they have been in the past. Let's take a look at some of the tailwinds that are behind equities.

So if we move to Chart 20, this is a look at the credit markets and the stock markets against GDP. I know you like this chart because it shows that the total equity market as a percentage of GDP is about one third the size of the bond market. And from a stock investment standpoint, it clearly shows that the equity market is not flooded with an oversupply of stocks as we are currently with bonds.

Catherine: I find this chart very interesting. It says several things. One is I'm concerned about the quality of corporate earnings and the extent to which earnings are dependent on more and more government and corporate borrowing. One of the things it makes me think about is which companies are not going to be hurt if government borrowing and spending diminish. But perhaps even a more important issue is once that peak in fixed income changes, that's an awful lot of money in the fixed income market that's got to go someplace.

You would think it would go into equities. Again, I look at this, and I think, "Well, we have to have a planetary debt-for-equity swap." And of course, it goes back to, "Is this going to be nice or rough?"

Chuck: Yes, this is one of the big questions. We can ride this wave like a surfboard or get drowned by it. Something's going to change, and it's something we need to be prepared to manage.



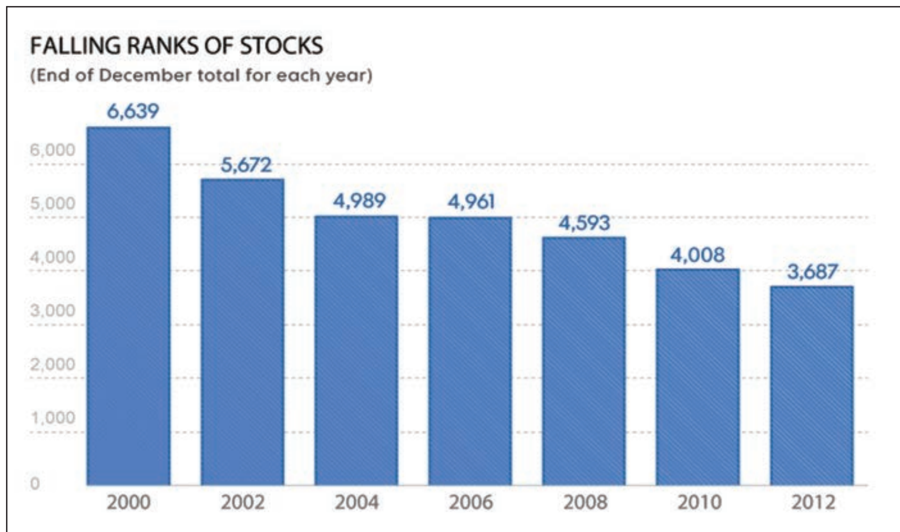
Chuck: Agreed. All right, let's take a look at the next chart, which is foreign ownership of U.S. stocks. In the prior discussion, I talk about how households outside the United States have very light equity exposure compared to here in the U.S. What you can see is that this the dark blue line on this chart shows that the actual increase in foreign ownership in U.S. companies is rising, and rising at a pretty good clip, except if you notice that one little dip there back in I think it's the early '90s. Since then, it's been growing at a

really nice clip.

Catherine: It's remarkable because this growth tracks very much the process of globalization we've been going through. So we pass the Uruguay Round of GATT in the early '90s and create the WTO in 1995 and globalization really takes off with much money shifting out of the United States. So U.S. investors shifting assets abroad and foreign investors shifting back in. To me, you're talking about something as this money shifts that can have profound changes in the way companies and the way politics are managed. Now institutions need to be responsive to a much more globalized constituency than before, whether it's customers or shareholders. So globalization is happening. This trend is just going to continue.

Chuck: Yes, I agree. Well, that's why I love talking to you, because I didn't even think about that. But that's probably a huge reason for the reason we were seeing such large growth.

Catherine: We saw the same dynamic happen earlier in the bond market — American politicians suddenly becoming much more sensitive to global creditors. It's all part of this process



Chuck: Okay — let's jump right into Chart 22, which is the shrinking supply of United States stocks.

Catherine: This is shocking

Chuck: Yes, me, too, because I've been telling everybody for years that there are somewhere between 5,000 and 7,000 stocks available on the U.S. stock markets you can invest in, when in fact I've been wrong. I didn't realize this, and so it was a shock. It really shows that since 2000 we've been at a pretty decent clip reducing the number of stocks available on the markets. Of course, some of this could be explained by the 2000 and 2008 stock bubbles.

In 1995 globalization really takes off with much money shifting out of the United States.

Because a lot of those companies went out of business. But the fact is that we're almost on the pace of a 40 percent drop over the last 12 years.

Catherine: Well, part of it is when interest rates are coming down the way they have, it makes tremendous economic sense for companies to borrow money and use that money to buy other companies or buy their equities. And so to me, mergers and acquisitions explain some of it, including companies taking themselves private. So we see Michael Dell trying to take his company private, and so the stock leaves the exchange. So part of this is falling interest rates. Of course if that changes then you've got companies who've got every reason to want to finance with equity or go into the markets through IPOs because equity suddenly becomes a lot more attractive as a way to finance than debt.

Chuck: Yes — either way, for whatever the reason may be, we know that it creates a real positive tailwind for equities, because as the supply of something shrinks, the prices tend to follow along in the upward direction.

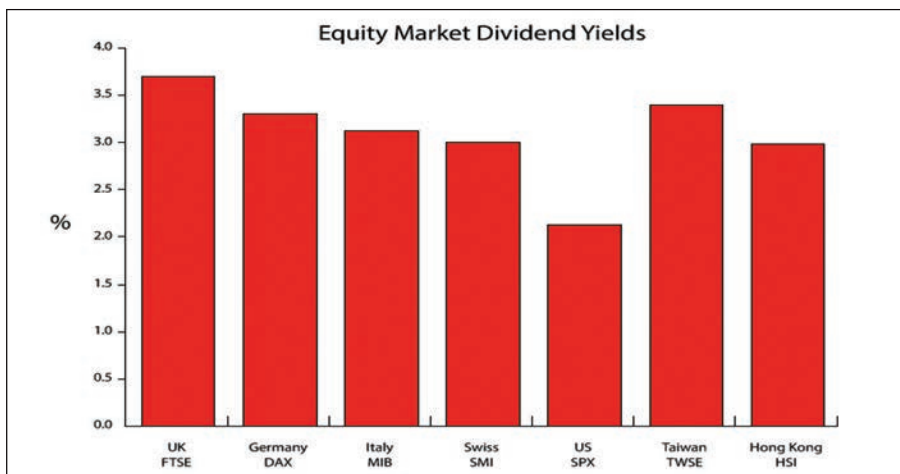
Catherine: Right, and I think this is one of the reasons why there's been such a push to get the JOBS Act passed and permit crowd funding to happen for entrepreneurs and early venture capital. I talked about this on the 1st Quarter Wrap Up last week. I just posted something on the blog two weeks ago describing estimates of crowd funding volumes to double next year. Instead of coming from social projects, the increase is coming from equity — early equity investments. So my guess is it's to help kick-start a move to and increase in equities.

Estimates of crowd funding volumes to double next year.

Chuck: Interesting. Well, there's a lot of buzz around that sector of the market, isn't there.

Catherine: Yes. I'm always saying to the subscribers, "Beware! Beware! Beware!"

Chuck: Exactly — especially in the early phase of these things, everyone has to be most careful.



Chuck: Okay — let's jump right into Chart 23, which is "Equity Market

Dividend Yields." In a world where ten-year sovereign debt yields somewhere around 2%, those investors that are hungry for yield will find this chart compelling. It shows worldwide equity yields at a very favorable level as compared to fixed income alternatives. In addition not only to the competitive yields, in my mind there's way more upside potential with stocks whereas with bonds at current prices today, I think the probability of them being able to eke out any upside is really low.

Catherine: Right — so the chance of a dramatic decrease in yields in the bond market is very, very small. And so you don't see how the income that you're getting from bonds can compare. Now, this is why this chart absolutely underscores the importance of the analysis you showed us earlier about the potential volatility on bonds. Traditionally, as we've been going through this dropping yield environment, we've gone to bonds for safety of principal amounts. If that could change if and when the turn comes — **and as you've pointed out, the turn isn't here yet** – but if and when that turn comes, then the volatility in bonds could be as great, if not greater than on equities.

Chuck: Absolutely. So what's the advantage then?

Catherine: Right — if you're going to have equal amounts of volatility, then why not have some growth potential?

Chuck: Well, in addition to maybe potentially greater yields, too.

Catherine: Right.

Chuck: All right — let's look at the final chart. This is a study done by the folks at Guru Focus. What they did was they put together a model in an attempt to estimate annualized stock returns for various countries around the world for the next ten years. If you're interested in seeing more details on the study, you can go to their website, www.GuruFocus.com. The methodologies and variables that they used are similar, but not exactly to the others who have used models to predict the stock future returns.

Some people that I follow that do the exact same thing are Doug Short, John Hussman and Gary Schilling. What I want people to take away from this is not the specific projected returns. Don't look at China here and say that, "Okay, this study says I'm going to get 30 percent return for the next 10 years." That's not really what you should take from this. What you really want to grasp is where those positive returns are going to come from. Clearly from the results, you can see that the emerging markets provide the best opportunity for returns going forward.

That brings us right back around to your and my thesis of successful in-

vesting that lay within the focus of things that are in a primary trend.

Catherine: Right. So what we're saying is, you know, the first quarter said fundamentals don't matter. But what we're saying is in the long run, yes, fundamentals do matter.

Chuck: Exactly

Catherine: The three primary trends you hear Chuck and me talk about on the equity overviews is, one, the emerging markets, two is technology and innovation, and three are tangibles in the sense that we have more people and the same amount of land and things, and the pressure of a growing and globalizing population. So clearly emerging markets are one of the primary trends. It's one that is very long-lived.

Chuck: Yes.

CLOSING

Catherine: Chuck, this has been an extraordinary presentation. I know that this represents years of work and analysis on your part. You've been very generous by sharing it with you. I really appreciate it.

In closing, I want to stress again the big questions. We've been in one paradigm, and a very long-term bull market in bonds has financially driven that paradigm. That's got to change. We know it can't continue. We can't fall into negative interest rates and stay there.

So the question is, "How and when are we going to turn? Where is all this money that's piled up in the fixed income markets going to go?" And of course, "Is it going to go to equities?" We don't know the answers to these questions. What it says is there's potential for great change. What that says is this is time to pay attention and to understand that a lot of what we take for granted is not a natural law; it's a condition created by this long-term bull market in bonds. We need to start being prepared to change our assumptions of how things are going to work.

So the question is, "How and when are we going to turn? Where is all this money that's piled up in the fixed income markets going to go?"

Chuck: Yes.

Catherine: You agree.

Chuck: Well, I couldn't say anything — I mean, that just wraps it up I think perfectly.

Catherine: The thing I always wonder about is if I'm listening to this — if I'm a *Solari Report* subscriber, what's my takeaway? I think everybody's different. Their asset positions are different. Their needs are different, and their situation

is different. I'm loath to give generic rules. The one thing I would say is when you're coming into a period with this much potential change, that in one sense the risk levels are rising across the board in all asset categories, and now is the time to go to quality.

You want to have quality in the companies that you invest in. You want to have quality in the issuers that you invest in. You want to have great governance and management. When the world rocks and rolls, and this is really a rock-and-roll kind of situation, quality in leadership counts for a lot. It's the leadership that can take advantage of change and can manage the risks even when the going gets tough. So I would say go to quality. This includes having quality in your custodian. We have financial institutions that are engaged in a lot of speculation and are stretched thin in very volatile assets, including derivatives.

Now is a time to have custodians who see their business as serving you as opposed to engaging in the speculation. So you can't be too careful in terms of quality. So I would say go to quality.

Then the second thing I would say is pay attention, because there are things we didn't have to pay attention to in the past that we're going to have to pay attention to now. Finally, as you say Chuck, now is not the time to take on additional risk.

Chuck: Yes — not trying to give specific advice — but it's not the time to take on additional risk, and I don't think it's the time to chase yields with your bond position. It's not time to try and eke out that return. Look for performance. We haven't fixed any of the risks that were there in 2008 and 2009. All we've done is add to them. So while the markets can be positive for three years or four years since then, at some point in we are likely to revert to the mean. At some point in time risks are going to take over. People are going to be very, very concerned. So the one keyword from here for me is balance.

Catherine: Right — balance.

Chuck: Balance.

Catherine: Well, Chuck, thank you again very much. We're going to be back with you in a quarter for the 3rd Quarter Equity Review. I am sure we'll have a lot to talk about as well.

Chuck: Thank you, Catherine. It was great being here with you, and I look forward to next quarter.

The one thing I would say is when you're coming into a period with this much potential change, that in one sense the risk levels are rising across the board in all asset categories, and now is the time to go to quality.

The one keyword from here for me is balance.

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